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SURFACE TRANSPORTATION BOARD

DECISION

Docket No. EP 552 (Sub-No. 22)

RAILROAD REVENUE ADEQUACY—2017 DETERMINATION

Docket No. EP 558 (Sub-No. 21)

RAILROAD COST OF CAPITAL—2017

Docket No. EP 750

UNIFORM RAILROAD COSTING SYSTEM—2017 CALCULATIONS

Digest:[1] The Board is seeking comment on whether one-time adjustments to its 2017 annual cost of capital determination, revenue adequacy determination, and Uniform Railroad Costing System calculations to remove the accounting impacts of the Tax Cuts and Jobs Act on rail carriers' deferred tax liability would be appropriate in order to more accurately reflect the rail carriers' financial state for 2017 and, if so, the appropriate adjustment methods.

Decided: July 27, 2018

On February 8, 2018, the Board instituted a proceeding in Railroad Cost of Capital—2017, Docket No. EP 558 (Sub-No. 21), to update the railroad industry's cost of capital for 2017. The Board received comments from the Association of American Railroads (AAR) providing the information used to make the annual cost of capital determination. The supporting data submitted with AAR's filing reflects significant accounting adjustments to the rail carriers' 2017 financial reports due to a one-time revaluation of deferred tax liabilities resulting from the reduction of the federal corporate income tax rate in the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

The Tax Cuts and Jobs Act, enacted December 22, 2017, reduced the federal corporate income tax rate from a maximum of 35% (see 26 U.S.C. § 11(b) (2012)) to a flat 21%, effective January 1, 2018. See Tax Cuts and Jobs Act § 13001(a). Because Generally Accepted Accounting Principles require that deferred tax assets and liabilities be revalued in the year in

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[1] The digest constitutes no part of the decision of the Board but has been prepared for the convenience of the reader. It may not be cited to or relied upon as precedent. See Policy Statement on Plain Language Digests in Decisions, EP 696 (STB served Sept. 2, 2010).

which the change in tax rate is enacted,[2] rail carriers revalued their deferred tax liability in 2017, even though the reduced tax rate did not go into effect until January 2018. As a result of the revaluation, rail carriers made one-time, downward adjustments to their deferred tax liabilities on their financial statements, as reported to both the Securities and Exchange Commission and to the Board and accounted for the reduction in deferred tax liabilities as income. See FASB ASC 740-10-45-15 ("[W]hen deferred tax accounts are adjusted . . . for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date"). Accordingly, the financial statements for each of the four Class I railroads comprising the "composite railroad"[3] used to calculate the annual railroad cost of capital (CSX Corporation; Kansas City Southern; Norfolk Southern Corporation; and Union Pacific Corporation) show substantial increases in non-cash income. The increases in reported net income range from $483.9 million to $6,479 million.[4] See AAR Comment App. K at 1-4, R.R. Cost of Capital—2017, EP 558 (Sub-No. 21).

The carriers' accounting adjustments will affect several Board determinations and calculations for 2017, including the cost of capital and revenue adequacy determinations, as well as Uniform Railroad Costing System (URCS) calculations.[5] The significant increases in net

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[2] See Financial Accounting Standards Board (FASB) Accounting Standard Codification (ASC) 740-10-25-47.

[3] The composite railroad includes railroads that meet all of the following criteria during the review year: (1) the company is a Class I line-haul railroad; (2) if the Class I railroad is controlled by another company, the controlling company is primarily a railroad company and is not already included in the study frame (a company is considered to be primarily in the railroad business if at least 50% of its total assets are devoted to railroad operations); (3) the company's bonds are rated at least BBB by Standard & Poor's and Baa by Moody's; (4) the company's stock is listed on either the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (NASDAQ); and (5) the company has paid dividends throughout the review year. See Revisions to the Cost-of-Capital Composite R.R. Criteria, EP 664 (Sub-No. 3) (STB served Oct. 25, 2017); R.R. Cost of Capital—1984, 1 I.C.C.2d 989 (1985).

[4] Between January and March 2018, BNSF Railway Company; CSX Transportation, Inc.; Grand Trunk Corporation; Kansas City Southern Railway Company; Norfolk Southern Corporation; Soo Line Corporation; and Union Pacific Railroad Company sought approval, pursuant to 49 C.F.R. § 1201, Instr. 1-2(d)(7), to treat the 2017 accounting adjustments to their deferred income tax liabilities as "extraordinary items" in their annual financial reports to the Board. Those requests were denied by the Acting Director of the Office of Economics in March 2018. A copy of the request letters and Acting Director's decisions may be found on the Board's website at https://www.stb.gov/stb/industry/econ_reports.html (under the "Economic Correspondence" header).

[5] The Board publishes annually the rates of return of each Class I railroad, as well as the cost of capital experienced by the rail industry, in sub-numbered proceedings of Docket Nos. EP 552 and EP 558, respectively. See 49 U.S.C. § 10704(a)(2) & (3). The Board also calculates annually the variable and total unit costs for Class I railroads using URCS, its general purpose costing methodology that is used for a variety of regulatory functions. See, e.g., 49 U.S.C.

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income reported on the carriers' financial statements that are attributable to the adjustment in deferred tax liability, however, may not be truly representative of the carriers' financial state for 2017. In light of the one-time accounting adjustments reflected in the carriers' financial statements, the Board is considering whether to make corresponding one-time adjustments to its 2017 cost of capital determination, revenue adequacy determination, and URCS calculations by removing the accounting impacts of the Tax Cuts and Jobs Act on deferred tax liability. The Board believes that such an adjustment to the cost of capital determination, revenue adequacy determination, and URCS calculations might more accurately reflect the financial state of the railroad industry in 2017 and facilitate year-over-year comparisons.[6]

Accordingly, the Board is seeking comment on whether one-time adjustments would be appropriate so that the Board's annual determinations and calculations are more representative of the rail carriers' financial state for 2017 and, if so, on the potential adjustment methods. The Board sets forth below an option for addressing the accounting impacts on the Board's 2017 determinations and calculations, but also invites interested parties to comment on potential alternative methods.

2017 Railroad Cost of Capital

The decrease in deferred tax liability and corresponding increase in net income resulting from the rail carriers' revaluation of their deferred tax liabilities would affect the Board's 2017 cost of capital determination through the Morningstar/Ibbotson multi-stage discounted cash flow (MSDCF) model. The Board uses MSDCF, together with a Capital Asset Pricing Model, to estimate the cost of common equity capital.[7] Cash flows are an essential element in the MSDCF model, and both deferred taxes and net income factor into cash flows.

Accordingly, the Board is considering whether to remove the accounting impacts of the carriers' deferred tax revaluations by adjusting the deferred tax and net income figures in the supporting data filed by AAR in Railroad Cost of Capital—2017, Docket No. EP 558 (Sub-

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§ 10707(d)(1)(A)-(B) (requiring the use of URCS for the jurisdictional determination in railroad maximum rate reasonableness proceedings).

[6] The Board's predecessor, the Interstate Commerce Commission, made one-time adjustments to its 1986 and 1988 revenue adequacy determinations. See R.R. Revenue Adequacy—1988 Determination, 6 I.C.C.2d 933, 947-949 (1990) (adjusting the deferred tax balance to account for a reduction in the corporate income tax rate by the Tax Reform Act of 1986, Pub. L. No. 99–514, 100 Stat. 2085, and a revision to certain accounting principles); R.R. Revenue Adequacy—1986 Determination, 3 I.C.C.2d 966, 970 (1987) (modifying the computation of the return on investment through subtraction of deferred income tax reserves from the investment base and the use of depreciation accounting).

[7] The cost of equity in a discounted cash flow model is the discount rate that equates a firm's market value to the present value of the stream of cash flows that could affect investors.

No. 21).[8] Specifically, the Board would increase the carriers' deferred taxes figures by the amount of deferred tax liability removed by the revaluation, while also removing the same amount from the carriers' net income figures. The Board would apply this adjustment to the cash flow calculation for each of the four carriers that comprise the "composite railroad" used to calculate the annual railroad cost of capital.[9]

2017 Railroad Revenue Adequacy

The Board calculates the annual revenue adequacy figure for each Class I railroad by comparing the year's cost of capital figure to the same year's rate of return on net investment data, which carriers report in their annual R-1 Schedule 250 filings. A railroad is considered revenue adequate under 49 U.S.C. § 10704(a) if it achieves a rate of return on net investment equal to at least the current cost of capital for the railroad industry. See R.R. Revenue Adequacy—2016 Determination, EP 552 (Sub-No. 21), slip op. at 1 (STB served Sept. 6, 2017); see also Standards for R.R. Revenue Adequacy, 364 I.C.C. 803, 807 (1981), modified, 3 I.C.C.2d 261 (1986), aff'd sub nom. Consol. Rail Corp. v. United States, 855 F.2d 78 (3d Cir. 1988). Because deferred taxes and net income are included on the carriers' Schedule 250 filings, the changes to these figures due to the reduced federal corporate income tax rate would affect the Board's 2017 revenue adequacy determination. Specifically, the revaluation of deferred tax liabilities during the fourth quarter of 2017 creates an inconsistency between the carriers' 2017 beginning-of-year figures (calculated at a 35% tax rate) and end-of-year figures (calculated at a 21% tax rate), which are used to calculate revenue adequacy.

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[8] Western Coal Traffic League (WCTL) replied to AAR's submission in Railroad Cost of Capital—2017 (and also docketed its reply in Petition of the Western Coal Traffic League to Institute a Rulemaking Proceeding to Abolish the Use of the Multistage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Equity Capital (Petition to Abolish MSDCF), Docket No. EP 664 (Sub-No. 2)). WCTL argues that the MSDCF model is generally unsuitable for estimating the railroad cost of equity and should not be used to determine the cost of capital, especially in 2017, given the accounting impacts of the Tax Cuts and Jobs Act. WCTL Reply 4-6, R.R. Cost of Capital—2017, EP 558 (Sub-No. 21). WCTL petitions the Board to reopen various decisions in Docket No. EP 664 (Sub-No. 2) to adjust the cost of capital methodology and to delay issuing the 2017 cost of capital until the Board has done so. (WCTL Reply 6-7, R.R. Cost of Capital—2017, EP 558 (Sub-No. 21).) Subsequent pleadings were filed by both AAR and WCTL. Because WCTL is challenging the general suitability of the MSDCF model for the Board's cost of capital determinations, the Board will address WCTL's arguments in a separate decision in Docket No. EP 664 (Sub-No. 2). See R.R. Cost of Capital—2012, EP 558 (Sub-No. 16), slip op. at 10 (STB served Aug. 30, 2013); Methodology to be Employed in Determining the R.R. Indus. Cost of Capital, EP 664, slip op. at 18 (STB served Jan. 17, 2008).

[9] Because the cost of capital calculation is based on five years of data, a one-time adjustment made in 2017 would flow into the next four years' calculations, although the adjustment to the rail carriers' deferred tax and net income figures would be made in 2017 only.

The Board is considering whether to adjust the carriers' Schedule 250 filings to remove these accounting changes from the carriers' end-of-year figures.[10] Specifically, for each of the seven Class I carriers, the Board is considering removing the increase in net income from Line No. 1, "Combined/Consolidated Net Railway Operating Income for Reporting Entity," and adding the deferred income tax credits back in to Line No. 12, "Accumulated Deferred Income Tax Credits."[11]

2017 URCS

The revaluation of the carriers' deferred taxes would also affect the Board's 2017 URCS calculations. Specifically, the decrease in deferred tax liabilities resulting from the revaluation are reflected in the carriers' annual R-1 Schedule 200 filings, which the Board relies on to complete its URCS calculations. To remove the accounting impacts of the revaluation from its 2017 URCS calculations, the Board is considering adjusting Line No. 48, "Accumulated Deferred Income Tax Credits Balance at Close of Year," of Schedule 200 for each Class I carrier by adding back in to that figure the amount of deferred taxes removed due to the revaluation. If the Board were to make this adjustment, the Board would use a 35% tax rate to calculate the pre-tax cost of capital used in the URCS calculations. Using a 35% tax rate—rather than the new 21% tax rate—would be consistent with excluding the accounting impacts of the revaluation.

Revised Financial Data for Adjustments

To ensure that the Board has the financial data necessary to implement any adjustments in an expeditious manner, the Board will require all Class I carriers to file revised figures with the accounting impacts of the rail carriers' deferred tax revaluations removed for Line Nos. 1 and 12 of Schedule 250; Line No. 48 of Schedule 200; and the "Net Income" and "Deferred Taxes" lines of the cash flow calculation, including supporting documentation, for the cost of capital determination (see AAR Comment App. K, R.R. Cost of Capital—2017, EP 558 (Sub-No. 21)). The Board would only use this data if it adopts adjustments.

In conclusion, the Board is seeking comments on whether one-time adjustments to its 2017 cost of capital determination, revenue adequacy determination, and URCS calculations to remove the accounting impacts of the Tax Cuts and Jobs Act on rail carriers' deferred tax liability would be appropriate and, if so, the appropriate adjustment methods. The Board also welcomes interested parties to comment on alternative methods to address these accounting

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[10] The carriers' beginning-of-the-year figures do not reflect the revaluation of deferred tax liability and therefore would not need to be adjusted. Any adjustment made to the end-of-year figures for the 2017 revenue adequacy determination would not be carried over into the carriers' 2018 beginning-of-year Schedule 250 figures.

[11] Such an adjustment would be similar to the adjustment made by the ICC in its 1988 revenue adequacy determination, in which the ICC adjusted carriers' beginning-of-year balances to account for a reduction in the corporate income tax rate resulting from the Tax Reform Act of 1986 and a change to the principle on accounting for income taxes. See R.R. Revenue Adequacy—1988 Determination, 6 I.C.C.2d 933, 947-949 (1990).

impacts to ensure that the Board's 2017 determinations and calculations are representative of the financial state of the railroad industry in 2017.

It is ordered:

1. Comments are due by August 16, 2018. Reply comments are due by September 5, 2018.

2. All Class I railroads must file by August 16, 2018, revised figures with the accounting impacts of the carriers' deferred tax revaluations removed, as described above.

3. A copy of this decision will be served on all Class I rail carriers.

4. This decision is effective on its service date.

By the Board, Board Members Begeman and Miller.